

SEARCH

Select an area to search

Search

Home > Businesses > Help & Resources > Legal Library > Directives > Directives - By Decade > (2000-2009) Directives >

Directive 02-5: Value of Depletable Property in the Property Factor

Introduction: The property factor of the income apportionment formula provides that "property owned . . . shall be valued at its original cost." See G. L. c. 63, Â§ 38(d). Original cost is defined in 830 CMR 63.38.1(7) as the basis of property for federal income tax purposes, adjusted for improvements and partial dispositions, "but not adjusted for subsequent depreciation." While depletion is similar in concept to depreciation, it is not identical, and this Directive concludes that the conceptual differences between depletion and depreciation merit a different treatment vis-Ã -vis the property factor calculation.

Issue: Whether depletable property should be valued at original cost without consideration of depletion allowances, or whether depletable property should be valued at original cost net of depletion allowances, for purposes of the property factor of the income apportionment formula.

Directive: Depletable property should be valued at original cost net of depletion allowances, for purposes of the property factor of the income apportionment formula.

Discussion: General Laws chapter 63, section 38(d) states in pertinent part:

The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this commonwealth during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the taxable year. Property owned by the corporation shall be valued at its original cost.

"Original cost" is defined in 830 CMR 63.38.1(7)(e)1 as "the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, as for example, by reason of sale, exchange, or abandonment, but not adjusted for subsequent depreciation."

Section 611 of the Internal Revenue Code ("IRC") provides for "a deduction in computing taxable income [of] a reasonable allowance for depletion" in the case of mines, oil and gas wells, other natural deposits and timber. Treasury regulations section 1.611-3(b)(1) states that "[t]he depletion of timber takes place at the time timber is cut . . . ." and further provides that if gross income corresponding to the cut timber is not received at the time the timber is cut, the depletion allowance which otherwise would be allowable, "shall be included as an item of cost in the closing inventory of such products for such year."[\(1\)](#)

The depletion allowance is a function of the number of timber units cut and the "depletion unit." The depletion unit is calculated at the time of the acquisition of the timber but is adjusted for subsequent timber growth to reflect more accurately the timber volume.[\(2\)](#) The basic theory underlying the depletion allowance was described by Justice Brandeis in *United States v. Ludey*, 274 U.S. 295, 302 (1927):

The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed.

The Supreme Court subsequently addressed the subject of depletion in *Helvering v. Bankline Oil Company*, 303 U.S. 362 (1938). In *Bankline*, as in *Ludey*, the Court made clear that depletion is allowable as a deduction at the time that the mineral at issue is actually taken from the ground or "wasted." In *Bankline* the Court stated, "[The depletion deduction] is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production." *Id.* at 366-67.

Both the operation of IRC Â§ 611 and the theory underlying the depletion deduction as expressed by the Supreme Court make clear that the deduction is intended to compensate for the exhaustion of the mineral or timber reserve at the time at which a portion of the mineral or timber is disposed of. Unlike the depreciation deduction, which is taken on a year-by-year basis under an economic recovery model until the earlier of the disposition of the underlying asset or the expiration of the depreciable life, the depletion deduction is allowable only in the year in which a portion of the timber or mineral is actually disposed of. Since the depletion allowance is an allowance taken on the occasion of a partial disposition of the underlying mineral or timber, it should be deducted at that time from the acquisition basis of the property for purposes of the property factor.

Effective Date: The principles set forth in this directive will apply to taxable years beginning on or after January 1, 2001.

/s/ Alan L. LeBovidge  
Alan L. LeBovidge,  
Commissioner of Revenue

ALL:DMS:atf  
104111

May 10, 2002

DD 02-5

[ [Return to Online Legal Library](#) ]

Footnotes:

1. This latter provision of the regulations would operate, for example, in the circumstance in which a timber company is vertically integrated and not only owns and cuts its own timber, but utilizes that timber in the production of paper products. In that case, the depletion allowance is taken as a deduction in the years in which the corresponding paper products are sold. As an accounting matter, the depletion allowance is properly reserved as a deduction by simply including it as a cost in the closing inventory of the paper products for the year. ([return to text](#))

2. See Treasury regulations section 1.611-3(e). See also *Burnett*, 610 T.M. Timber Transactions, VI. D. ([return to text](#))